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# Non-GAAP Measures in the Wake of COVID-19


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# Objectives

- Discuss non-GAAP financial measures regulation and guidance
- Examine recent SEC guidance on key performance indicators and metrics used in MD&A and other company disclosures
- Examine recent SEC guidance on non-GAAP financial measures in COVID-19 disclosures
- Examine recent SEC comment letters on non-GAAP financial measures and KPIs
- Look at SEC enforcement actions related to non-compliance
- Examine audit committee and management roles in compliance and effective disclosure controls

# Non-GAAP Financial Measures: Regulation

# What is a Non-GAAP Financial Measure?

- A numerical measure of historical or future performance, financial position, or cash flows that either:
  - Excludes (or adjusts) amounts included in the most comparable GAAP measure; or
  - Includes (or adjusts) amounts excluded from the most comparable GAAP measure

- Operating and other financial measures and ratios or statistical measures are **not** non-GAAP financial measures if exclusively calculated from:
  - Financial measures calculated in accordance with GAAP; and/or
  - Operating or other measures that are not non-GAAP financial measures

# Item 10(e) of Regulation S-K

- Applies only to non-GAAP financial measures in SEC-filed documents
- Affirmative requirements:
  - Most directly comparable GAAP measure must receive equal or greater prominence
  - Must provide a quantitative reconciliation to GAAP – If prospective, required unless unreasonable effort
    - If non-GAAP financial measure is derived from or based on a measure calculated in accordance with U.S. GAAP, the reconciliation must be to U.S. GAAP
    - If reconciliation to prospective amounts would require unreasonable effort, disclose that fact and identify the information that is unavailable and its probable significance

# Item 10(e) of Regulation S-K *(cont'd)*

- Disclose how management uses the measure and why management believes the measure provides useful information to investors
- Negative requirements
  - Cannot exclude a cash charge from a liquidity measure – except EBIT and EBITDA
  - Cannot exclude items identified as nonrecurring, infrequent, or unusual if likely to recur – two-year window (forward and backward)
  - Cannot include on the face of or in footnotes to financial statements
  - Cannot include on the face of *pro formas* required by Article 11 of Regulation S-X
  - Cannot have a title that is the same as or similar to GAAP measures

# Regulation G

- Regulation G generally applies to all public disclosures that contain non-GAAP financial measures, including press releases, investor presentations, and conference calls, whether such disclosure is made in print, orally, telephonically, by webcast, or by broadcast
- In connection with the disclosure of a non-GAAP financial measure, Regulation G requires the presentation of:
  - The most directly comparable financial measure calculated and presented in accordance with GAAP; and
  - A reconciliation of the non-GAAP financial measure to the most directly comparable GAAP measure
- For public disclosure made orally, telephonically, or by webcast, broadcast, or similar means, an issuer may post the reconciliation simultaneously to its website and announce the location to investors of the presentation that includes the non-GAAP financial measure

# Foreign Private Issuer ("FPI") Exemptions

- Regulation G **does not apply** to an FPI **if all** of the following conditions are met:
    1. The securities are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States
    2. The non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP <u>**and**</u>
    3. The disclosure is made by or on behalf of the FPI outside the United States, or is included in a written communication that is released by or on behalf of the FPI outside the United States

# FPI Exemptions *(cont'd)*

- Regulation S-K 10(e)(1)(ii) exempts FPIs when using a non-GAAP measure in Form 20-F or a registration statement if the measure is:
  - Required or expressly permitted by the local GAAP principles used in the FPI's primary financial statements and
  - Included in the FPI's annual report or financial statements
- Form 40-F (filed by Canadian issuers using MJDS) is not subject to Regulation G or Item 10(e) of Regulation S-K

# Non-GAAP Financial Measures: Compliance & Disclosure Interpretations (“C&DIs”)

# Inherently Misleading Non-GAAP Measures

- **Question 100.01** – A performance measure that excludes normal, recurring, cash operating expenses necessary to operate the business
- **Question 100.02** – A non-GAAP measure that adjusts a particular charge or gain in the current period and for which other, similar charges or gains were not also adjusted in prior periods, unless the change between periods is disclosed and the reasons for it explained
- **Question 100.03** – A non-GAAP measure that is adjusted only for nonrecurring charges when there were nonrecurring gains that occurred during the same period
- **Question 100.04** – A non-GAAP revenue measure that backs out the effect of GAAP revenue recognition and measurement principles applicable to a company's business

# Equal or Greater Prominence

- **Question 102.10** – Examples of non-GAAP presentations that fail to give "equal or greater prominence" to the comparable GAAP measure:
  - Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures
  - Presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure
  - A non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption)
  - Describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure
  - Providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures, or including the comparable GAAP measures in the same table

# Forward-Looking Non-GAAP Information

- **Question 102.10** – More prominence is given to a non-GAAP measure when an issuer excludes a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the "unreasonable efforts" exception without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence

# Tax-Related Effects

- **Question 102.11** - Disclosure of tax effects of non-GAAP measures
  - If a liquidity measure includes income taxes, it "might be acceptable" to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the disclosure should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability.
  - Adjustments to arrive at a non-GAAP measure should not be presented "net of tax." Rather, income taxes should be shown as a separate adjustment and clearly explained.

# Foreign Private Issuer C&DIs

- **Question 106.01**
  - Note to Item 10(e) of Regulation S-K permits an FPI to include in its filings a non-GAAP financial measure that otherwise would be prohibited by Item 10(e)(1)(ii) if, among other things, the non-GAAP financial measure is required or expressly permitted by the standard setter that is responsible for establishing the GAAP used in the FPI's primary financial statements included in its SEC filings
  - This C&DI explains a measure is "expressly permitted" if the particular measure is clearly and specifically identified as an acceptable measure by the standard setter that is responsible for establishing the GAAP used in the FPI's primary financial statements included in its SEC filings
  - The concept of "expressly permitted" can be also be demonstrated with explicit acceptance of a presentation by the primary securities regulator in the FPI's home country jurisdiction or market

# Foreign Private Issuer C&DIs *(cont'd)*

- **Question 106.02** – States that an FPI may incorporate by reference into a Securities Act registration statement only those portions of a press release furnished on a Form 6-K that do not include the non-GAAP financial measures
- Where an FPI wishes to incorporate by reference a portion or portions of the press release provided on a Form 6-K, the FPI should either:
  - Specify in the Form 6-K those portions of the press release to be incorporated by reference, or
  - Furnish two Form 6-K reports: One that contains the full press release and another that contains the portions that would be incorporated by reference (and specifies that the second Form 6-K is so incorporated)
- The FPI must also consider whether its disclosure is rendered misleading if it incorporates only a portion (or portions) of a press release

# Foreign Private Issuer C&DIs *(cont'd)*

- **Question 106.03** – Specifies that if an FPI publishes a non-GAAP financial measure that does not comply with Regulation G, furnishes the information in a report on Form 6-K and chooses to incorporate that Form 6-K report into a filed Securities Act registration statement (other than an MJDS registration statement), the FPI must comply with all of the provisions of Item 10(e) of Regulation S-K
- **Question 106.04** – Clarifies that if a Canadian company includes a non-GAAP financial measure in an annual report on Form 40-F it doesn't need to comply with Regulation G or Item 10(e) of Regulation S-K with respect to that information if the company files a non-MJDS Securities Act registration statement that incorporates by reference the Form 40-F
  - Information included in a Form 40-F is not subject to Regulation G or Item 10(e) of Regulation S-K

# COVID-19 Pandemic Non-GAAP Guidance

# COVID-19 Non-GAAP Financial Measures

- Issuers may want to present financial results while giving effect to the consequences of the COVID-19 pandemic
- SEC has addressed in Disclosure Guidance: Topic No. 9
  - Provides reminders and guidance related to the presentation of non-GAAP financial measures and reconciliation
  - Companies should use non-GAAP financial measures for the purpose of sharing how management and the Board of Directors are analyzing the current and potential impact of COVID-19 and not for the purpose of presenting a more favorable view of the company

# COVID-19 Non-GAAP Financial Measures *(cont'd)*

- In an earnings release, companies may reconcile provisional amounts based on a reasonable estimate, or a range of reasonably estimable GAAP results provided an appropriate explanation is provided
- "[I]n filings where GAAP financial statements are required, such as filings on Form 10-K or 10-Q, companies should reconcile to GAAP results and not include provisional amounts or a range of estimated results"
- Disclosure Guidance: Topic No. 9A addressed operations, liquidity, and capital resources disclosures companies should consider with respect to business and market disruptions related to COVID-19

# Non-GAAP COVID adjustments

- Originally, may have been presented as a one-time adjustment:
  - PPE, cleaning supplies, dividers, retrofitting
  - Lease termination costs
  - Supply chain disruptions
  - Workforce issues such as severance or bonuses for working onsite
- As the pandemic lasts, consider if treating COVID-19 adjustments as temporary may imply that ongoing costs are lower

# Examples of COVID-19 Non-GAAP Measures

- Adjustments should be directly related to the effects of the pandemic
  - Employee compensation and benefits arising from the COVID-19 pandemic
  - Cost containment related to workforce optimization due to reduced demand
  - Sanitizing and disinfecting costs
  - Personal protective equipment costs
  - COVID-19-related restructuring costs

# Key Performance Indicators ("KPIs")

# KPIs

- On January 30, 2020, the SEC issued guidance on KPIs and metrics used in MD&A
  - Commission-level guidance
  - Did not define KPIs or metrics
- Concerns similar to those raised with respect to non-GAAP financial measures
- The SEC has taken enforcement actions in recent years with respect to misleading KPIs

# Use of KPIs and Metrics

- May include non-financial or financial measures to describe performance of business
- Metrics may be company-specific or industry-specific
- May reflect external or macro-economic matters
- May be a combination of external or internal information

# Application of MD&A Rules to KPIs

- Include material information necessary to make the presentation of the metric, in light of the circumstances under which it is presented, not misleading
- Consider existing regulatory framework
  - Generally Accepted Accounting Principles
  - Requirements for non-GAAP financial measures under Regulation G or Item 10 of Regulation S-K
- Assess if additional information is necessary to provide context for KPI presented

# Examples of KPIs

| | | | |
|---|---|---|---|
| Operating margin | Same store sales | Sales per square foot | Total customers/ subscribers |
| Average revenue per user | Daily/monthly active users/usage | Active customers | Net customer additions |
| Total impressions | Number of memberships | Traffic growth | Comparable customer transactions increase |
| Voluntary and/or involuntary employee turnover rate | Percentage breakdown of workforce (*e.g.*, active workforce covered under collective bargaining agreements) | Total energy consumed | Data security measures (*e.g.*, number of data breaches or number of account holders affected by data breaches) |

# Disclosure to Accompany KPI Metrics

- Based on facts and circumstances, the following disclosure should accompany the metric:
  - Clear definition of the metric and how it is calculated
  - Statement indicating the reasons why the metric provides useful information to investors
  - Statement indicating how management uses the metric in managing or monitoring the performance of the business.

# Disclosures for Changes

- If company changes calculation method or presentation, consider disclosing, to the extent material:
  - Differences in the way the metric is calculated or presented compared to prior periods
  - Reasons for the change
  - Effects of change on amounts or other information being disclosed or previously reported
  - Other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company's performance or prospects
- Could be necessary to recast prior metrics

# Disclosure Controls and Procedures

**If**

KPIs and metrics are derived from company information,

**and**

the KPIs and metrics are material to investing or voting decisions,

**then**

company needs to consider whether it has effective disclosure controls and procedures in place for the disclosure of such KPIs and metrics.

# SEC Comment Letters

# SEC Comment Letters – Non-GAAP Measures

- **2016**: CorpFin issues C&DIs in May; staff tells companies to "self-correct" disclosures
- **2017**: Non-GAAP financials was the #1 topic in SEC comment letters
- **2018 to present**: Comments have declined but continues to be an area of focus
- **2020:** 94% of S&P 500 used at least one Non-GAAP financial measure
- Staff has frequently commented on the following broad topics/areas:
  - Reconciliation to the most directly comparable GAAP measure
  - Undue Prominence of non-GAAP financial measures vs. GAAP measures
  - Potentially misleading non-GAAP financial measures practices
  - Reasons for management's use, and usefulness to investors, of non-GAAP measures

# SEC Comment Letters – COVID-19 Disclosures

**2020 to Present**

- Comments focus on how companies are disclosing the effects and risks of COVID-19 on their business, financial condition and operations. Assess, disclose and:
  - Provide detailed, quantifiable discussion of COVID-19 impact on results, operations and liquidity
  - Enhance risk factor disclosures
  - Identify and discuss trends and uncertainties in MD&A
  - Follow CorpFin Guidance Topic Nos. 9 and 9A

# SEC Comment Letters – COVID-19 Disclosures

- Sample Comments:

- We note your general disclosures of the social and economic impacts from COVID-19. Please tell us what consideration you gave to providing **expanded information re specific impacts you have experienced to your operations and relevant metrics** resulting from the COVID-19 pandemic.  Refer to CF Disclosure Guidance: Topic No. 9 and 9A.
- **Quantify the effects** of COVID-19 in the first and second quarters of 2020 on your results of operations.
- Please **address more specifically how COVID-19 has impacted your services**, explaining the extent to which you have reopened your business and demand has returned for your business following the lockdown earlier this year..
- Please include the **specific known material impacts** of the pandemic on your **revenue, expenses, and net income**.
- Please revise to clarify further the impact of COVID-19 on your **operations and liquidity**. For example, it is unclear how sensitive your sources of liquidity are to coronavirus-related tenant defaults, whether disruptions from shutdowns have materially impacted your ability to operate and achieve your business goals, and whether COVID-19 has materially impacted your **funding sources, access to capital or ability to maintain financial covenants**.

- Please provide **separate and detailed risk factor disclosure** related to the impact of COVID-19 on your financial condition and operations.
- Please amend your **risk factor disclosure** to provide more detailed risks related to the COVID-19 pandemic, and your Management's Discussion and Analysis to provide information about your financial condition as a result of COVID-19, tailored to your specific facts and circumstances. See CF Disclosure Guidance Topic No. 9

# SEC Comment Letters – COVID-19 Disclosures

- Sample Comments:

- Given the amount of time that passed since the initial outbreak, please update your disclosure to discuss any **known trends and uncertainties** that have had or likely will have a material impact on your business and results of operations.
- Revise to disclose known trends and uncertainties related to COVID-19. Disclose how you expect COVID-19 to impact future operating results and **near-and-long- term financial condition and how that compares to current period**.
- Include disclosure in the MD&A to **describe and quantify any known trends and uncertainties** that have had, or you reasonably expect will have, a material impact on your business, revenue or results of operations due to COVID.
- Your disclose that due to COVID-19, there is a significant uncertainty surrounding the potential impact on your results of operations and cash flows. Ensure that your MD&A disclosure **addresses known trends in recognized revenue and whether you expect the trends to continue in periods subsequent to the recent reporting period**. That is, describe the underlying factors that are impacting trends in your revenue recognized including customer behavior and your ability to maintain the sales cycle. To the extent such trends remain uncertain, consider including key performance indicators to provide data on the impact on your near-term and long-term revenues, earnings, liquidity and cash flows.
- Please describe how COVID-19 is reasonably expected to **affect your financial condition, key performance metrics and results of operations.**

# SEC Comment Letters – COVID-19 Non-GAAP measures and adjustments

**2020 to Present**

- Not a lot of CorpFin comments on COVID-19 Non-GAAP measures and adjustments
- Some registrants were asked to explain nature of COVID-19 related adjustments
- *Sample SEC Comments*:

> - Please explain in further detail the nature of the expenses associated with COVID-19 that have been excluded from Normalized Funds from Operations.
> - Please clarify the nature of the adjustment titled "COVID-19 shelter in place restrictions on manufacturing activities." In your response, tell us how you reasonably quantified this adjustment, the length of time within the quarter that applied to its calculation, and the related amount applicable to the quarter ended June 30, 2020. We may have further comment upon reviewing your response.

# SEC Comment Letters – COVID-19 Non-GAAP adjustments

**Case 1:** REIT operating correctional and detention facilities, prisons.

- Q3 2020 10-Q: presented Normalized Funds from Operations, and reconciliation of net income to Normalized FFO for 9 months ended September 30, 2020 and 2019

| | For the Nine Months Ended September 30, | |
|---|---|---|
| **FUNDS FROM OPERATIONS:** | **2020** | **2019** |
| Net income | $ **82,141** | $ 146,912 |
| Depreciation and amortization of real estate assets | **84,599** | 80,366 |
| Impairment of real estate assets | **10,155** | 4,428 |
| Gain on sale of real estate assets, net of taxes | **(4,388)** | (287) |
| Funds From Operations | **172,507** | 231,419 |
| Expenses associated with mergers and acquisitions | **338** | 957 |
| Contingent consideration for acquisition of businesses | **620** | - |
| Expenses associated with COVID-19 | **10,985** | - |
| Expenses associated with changes in corporate tax structure | **5,045** | - |
| Deferred tax expense on Kansas lease structure | **3,085** | - |
| Start-up expenses | - | 9,480 |
| Goodwill and other impairments | **2,903** | 278 |
| Normalized Funds From Operations | $ **195,483** | $ 242,134 |



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# SEC Comment Letters – COVID-19 Non-GAAP adjustments *(cont'd)*

- **CorpFin Comment**: *Please explain in further detail the nature of the expenses associated with COVID-19 that have been excluded from Normalized Funds from Operations.*
- **Response**:
  – Based on interpretations of previous guidance from SEC, we concluded it was appropriate to exclude only items that were directly attributable to COVID-19 and were both: (A) Incremental to charges incurred prior to COVID-19 and not expected to recur once the pandemic has subsided and operations return to normal; and (B) Clearly separable from normal operations.
  – Taking available guidance into account, we determined that an adjustment to Normalized FFO to exclude certain direct and incremental costs associated with the Company's response in dealing with COVID-19 was appropriate during 2020. During 9 months ended Sep. 30, 2020 we excluded $11.0 million from Normalized FFO. The following table illustrates nature of the costs included in this adjustment:

| | |
|---|---|
| Frontline Workers - Hazard Pay | $ 6,303,344 |
| PPE Supplies (Masks, Face Shields, Gowns, Gloves, Thermometers) | 2,867,011 |
| Food Service Charges - Disposable Paper Products | 652,647 |
| COVID-19 treatment (Off-site Medical Care) | 607,144 |
| COVID-19 Testing | 378,315 |
| All Other | 176,098 |
| | **$ 10,984,559** |

# SEC Comment Letters – COVID-19 Non-GAAP adjustments *(cont'd)*

– In April 2020, we announced we would provide **incentive payments to our line and field staff, known as "hero bonuses"**, through Q2 2020, in appreciation of their service and dedication to Company's mission during COVID-19. This **additional hazard pay** was provided to all staff in our facilities in the form of an additional $500 incentive payment resulting in $6.3 million of incremental bonuses paid in Q2 2020. While we provided additional benefits, such as an additional day of paid time off, and an expanded paid leave policy for ill team members or those caring for a sick family member, these additional costs were *not* included in the adjustment to Normalized FFO, consistent with interpretive guidance available.

– We also incurred incremental expenses to **procure personal protective equipment** and other supplies such as masks, face shields, gloves, gowns, thermometers, and test kits, all of which we used to protect staff. The increased costs related to food service delivery resulted from **incremental charges from our third-party food service provider to provide disposable food service products such as trays, styrofoam cups, and utensils**, which were used to facilitate delivery of food in a socially distanced manner, allowing our facilities to avoid congregated cafeteria-style food service delivery.

– Costs related to COVID-19 treatment represent incremental costs incurred by us when an offender or resident in required medical services from third-party medical providers outside the facility we manage. **Medical costs** included represent only those charges where individual's treatment plan was **specifically COVID-19 related** and the medical provider billed us with a unique COVID-19 diagnosis code and without a comorbidity.

# SEC Comment Letters – COVID-19 Non-GAAP adjustments *(cont'd)*

**Case 2:** Computer chip/semiconductor manufacturer

- 8-K earnings press release: Company included adjustment for "COVID-19 shelter in place restrictions on manufacturing activities" to arrive at non-GAAP operating income

**RECONCILIATION OF GAAP OPERATING INCOME TO NON-GAAP OPERATING INCOME**

| | Three Months Ended March 31, 2020 | Three Months Ended March 31, 2019 |
|---|---|---|
| Operating income, as reported | $ 160.7 | $ 284.6 |
| Share-based compensation expense | 40.7 | 39.1 |
| COVID-19 shelter-in-place restrictions on manufacturing activities | 3.3 | — |
| Acquisition-related costs | 10.9 | 5.0 |
| Professional services associated with certain legal matters | 3.3 | — |
| IT security remediation | 1.1 | — |
| Excess capacity charges to normalize acquired inventory levels | — | — |
| Acquired inventory valuation costs | — | 1.8 |
| Amortization of acquired intangible assets | 248.5 | 176.9 |
| Special charges (income) and other, net | 17.2 | (23.3) |
| Non-GAAP operating income | $ 485.7 | $ 484.1 |

# SEC Comment Letters – COVID-19 Non-GAAP adjustments *(cont'd)*

- **CorpFin Comment**: *Please clarify nature of adjustment titled "COVID-19 shelter in place restrictions on manufacturing activities." In your response, tell us how you reasonably quantified this adjustment, length of time within quarter that applied to its calculation, and related amount applicable to the quarter ended June 30, 2020.*
- **Response**: Substantially all **our manufacturing activities were impacted by shelter in place restrictions** that prevented our sites from operating at normal levels. We calculated the equivalent number of days of lost production at each site and **quantified the costs associated with such impact (primarily compensation for idled employees, depreciation, utilities, and other fixed overheads**). In total, adjustment for COVID-19 shelter in place restrictions during the quarter ended March 31, 2020 of $3.3 million, represented lost production at 7 sites with an average of 5 days of lost production. **Amount of non-GAAP adjustment was quantified by accumulated fixed overhead costs for the period factored by the percentage of lost production days**. For quarter ended June 30, same calculation was performed and resulted in adjustment of $2.8 million, representing lost production at 10 sites with an average of 4 days of lost production.

  We had not closed our manufacturing operations or had production adversely impacted previously as a result of local government restrictions on employee movements and **do not expect to incur such costs again** during next two years after COVID-19 pandemic has passed. Adjustment included amounts that could be **objectively quantified** and **excludes other operational** costs (e.g., increased transportation and warehousing costs, increased cleaning costs, lower production levels and inventory markdowns) **that could not be clearly separated** from business conditions, changes in demand or Company actions.

# Most Common Non-GAAP Comments Issued to Companies

| | | | |
|---|---|---|---|
| Reconciliation to most directly comparable GAAP measure | Presenting non-GAAP measures with Undue Prominence | Potentially Misleading Non-GAAP financial measures | Reasons for management's use and usefulness to investors |
| Failure to identify and label as a non-GAAP measure; lack of or wrong reconciliation | Omitting comparable GAAP measures from earnings release headlines | Confusingly similar to GAAP measures or commonly accepted non-GAAP measures | Liquidity versus Performance measures |
| Reconciling EBIT or EBITDA used as a performance metric to lines other than net income | Non-GAAP measures precede GAAP measures in presentation | Individually tailored recognition and measurement methods | Non-GAAP financial measures of liquidity presented on a per share basis |
| Presentation of "free cash flow" metric | Using forward-looking non-GAAP measures without quantitative reconciliation or required disclosures | Presenting a performance measure that excludes normal, recurring, cash operating expenses | Presenting non-GAAP measures on a "net of tax" basis |

# Reconciling to the Most Directly Comparable GAAP Measure

- No Reconciliation
  - Failure to identify or label measure used as a non-GAAP financial measure
- *Sample SEC Comments:*

- We note the presentation of Adjusted EBITDA in your 2020 Outlook. **Please reconcile** this non-GAAP measure to the most directly comparable GAAP measure per Item 100(a)(2) of Regulation G.
- We note you intend to disclose the basis point change in Adjusted EBITDA margin in your preliminary financial results overview for the year ended December 31, 2019. Please disclose how Adjusted EBITDA margin is determined. In order to present this Non-GAAP financial measure using a basis point method, **the comparable GAAP measure must also be presented and defined**.
- **Please label** “Contribution Margin” **as a non-GAAP measure and present the disclosures and reconciliation required** by Item 10(e)(1)(i) of Regulation S-K.
- We note your presentation of Diluted EPS - As Adjusted. **Please provide a reconciliation of this non-GAAP measure to the most directly comparable GAAP measure**, Diluted EPS, in a more prominent manner, such as a tabular presentation, in accordance with Item 10(e)(1)(i) of Regulation S-K.



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# Reconciling to the Most Directly Comparable GAAP Measure *(cont'd)*

- Wrong Reconciliation
  - EBITDA; Free Cash Flow
- *Sample SEC Comments:*

- You reconciled **Non-GAAP Adjusted EBITDA** to operating income. Because it appears you use Adjusted EBITDA as a performance measure, the **most comparable GAAP measure should be net income**. See Question 103.02 of the C&DIs.
- You present a reconciliation of the non-GAAP measure **Adjusted EBITDA** to operating income. Please tell us your consideration of the guidance in Question 103.02 of the Non-GAAP Compliance and Disclosure Interpretations related to considering **net income** as the most directly comparable GAAP financial measure.
- You indicate that the most comparable GAAP measure to EBITDA and adjusted EBITDA is Earnings (loss) from continuing operations. Revise to reconcile these non-GAAP measures to Net earnings (loss) as the most comparable GAAP measure.
- In your earnings release, you define *Free Cash Flow* as Cash Flow from Operations less capital expenditures. This definition is commonly understood to represent a liquidity measure. As such, identify *free cash flow* as a liquidity measure rather than an operating performance measure. Ensure that **Free Cash Flow** is reconciled solely to its nearest US GAAP number, which here is **Operating Cash Flows**. As such, please remove information that reconciles Income (loss) from operations as your starting US GAAP measure to arrive at Cash Flow From Operations. See Question 102.07 of the C&DIs.

# Equal or Greater Prominence

- Omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures
- Providing non-GAAP measures discussion and analysis without a similar discussion and analysis of comparable GAAP measures in a location with equal or greater prominence
- *Sample SEC Comments:*

- **You discuss** the non-GAAP measures **Adjusted EBITDA** from continuing operations and adjusted EBITDA for your segments in your second quarter fiscal 2020 highlights and quarterly results of operations sections of your press release **without a discussion of the most directly comparable GAAP measures**. Tell us how you considered Item 10(e)(1)(i)(A) of Reg S-K and Question 102.10.
- In future filings, please revise your **bullet point highlights** and discussion in the 2nd par. to present the corresponding GAAP measure related to Adjusted EBITDA with equal or greater prominence.
- When presenting non-GAAP financial measures, please ensure that such disclosure is accompanied by the corresponding GAAP measure with equal or greater prominence. For example, on page *[X]* you refer to improving Adjusted EBITDA performance, **but do not include a similar discussion** referring to the impact of the **corresponding GAAP measure**. In addition, you present adjusted pro forma diluted EPS without presenting GAAP EPS. Please revise.
- Please revise your Adjusted EBITDA discussion to include the most directly comparable **GAAP measure with equal or greater prominence**.

# Equal or Greater Prominence *(cont'd)*

- Non-GAAP measures preceding the most directly comparable GAAP measures
- Using a style of presentation that emphasizes the non-GAAP measure over the comparable GAAP measure
- *Sample SEC Comments:*

- **Your non-GAAP measures** of adjusted EBITDA and net adjusted EBITDA margin **precede the GAAP measure**. Please ensure non-GAAP measures do not precede the most directly comparable GAAP measures in your next earnings release.
- Please revise your reconciliation in future filings to **begin with net income**, the most directly comparable measure, ensuring that the non-GAAP measure does not receive undue prominence.
- Please revise your presentations of non-GAAP measures to **begin reconciliations with GAAP results rather than non-GAAP** results. See Question 102.10.
- Please revise the format of your non-GAAP reconciliations here to reconcile from the most comparable GAAP measure to the corresponding non-GAAP measure for equal or greater prominence of the GAAP measure.
- We note that **in your executive summary you focus on key non-GAAP financial measures and not GAAP financial measures** which may be inconsistent with the C&DIs, specifically Question 102.10. We also note issues related to prominence within your earnings release.

# Equal or Greater Prominence *(cont'd)*

- Presenting a full income statement of non-GAAP measures or presenting a full-non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures
- *Sample SEC Comments:*

> - We note that you present a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures. Please revise your presentation to eliminate the presentation of a full non-GAAP income statement in your next earnings release. Refer to the guidance in Question 102.10 of the Compliance and Disclosure Interpretations Regarding Non-GAAP Measures.
> - Your presentation in Exhibit 99.1 of the 8-K appears to include a full income statement presentation of non-GAAP measures which does not comply with Question 102.10 of the Non-GAAP Financial Measures C&DIs.
> - We note you present full income statements of non-GAAP measures in tables A1 and A2. Please tell us how you considered the guidance in Question 102.10 of the updated Compliance and Disclosure Interpretation on Non-GAAP financial measures.

# Potentially Misleading Non-GAAP Measures

- Confusingly similar to GAAP measures or commonly accepted non-GAAP measures

- The title of your non-GAAP financial measure “**operating earnings before income taxes**“ is confusingly similar to that of a GAAP performance measure used by many companies. Please represent to us you will change the title of this measure.
- We note your reference to **Operating Cash Flow** or OpCF, a term which you use interchangeably with OIBDA - CapEx. Please note that "Operating Cash flow" is the same as, or confusingly similar to, "Net cash flow provided by operating activities," which is a GAAP financial measure. Please remove the reference in future filings. Refer to S-K Item 10(e)(ii)(E).
- Revise the title of your non-GAAP measure **net revenue** as it appears confusingly similar to titles or descriptions used for GAAP financial measures.
- **We note your definition of EBITDA**. Please note that measures calculated differently from EBITDA (as described in Exchange Act Release No. 47226) should not be characterized as EBITDA and their titles should be distinguished from EBITDA, such as Adjusted EBITDA. Refer also to Question 103.01.
- **You define the non-GAAP measure, EBITDA** as net earnings (loss) attributable to Company before interest expense, taxes on income, depreciation and amortization, impairment of long-lived assets, and impairment of goodwill. As you adjust net income (loss) for impairment charges to compute this measure, change title to something other than EBITDA.
- Your computation of “free cash flow” differs from the typical calculation of this measure (cash flows from operating activities as presented in the statement of cash flows under GAAP less capital expenditures). Please revise the title of this non-GAAP measure so it is not confused with free cash flow as typically calculated. Refer to Question 102.07.

# Potentially Misleading Non-GAAP Measures
*(cont'd)*

- Presenting a performance measure that excludes normal, recurring, cash operating expenses; characterization of adjustments

- Your earnings (loss) from continuing operations is adjusted for multiple items which you consider non-recurring such as costs to achieve operational initiatives, digital project implementation costs, transitions costs, foreign currency losses, contingent consideration, advisory fees, impacts of purchase accounting, and loss (gain) on asset disposals. **However, these items appear to have occurred as adjustments in multiple periods.** Please tell us how you concluded these adjustments are consistent with Item 10(e) of Reg S-K and Question 102.03 of C&DIs. Revise your disclosures to provide enough detail for readers to understand why you consider these adjustments to be non-recurring or revise to remove the reference of non-recurring when describing these.
- Your adjustment for cost to achieve operational initiatives include transformation efforts and restructuring. The adjustment is also significantly higher than restructuring costs as disclosed your financial statements footnotes. Please explain amount and nature of operational initiatives included in this adjustment and how they relate to your restructuring costs. Tell us how you considered Question 100.01 and whether these are normal, recurring, cash operating expenses.
- Your non-GAAP measures exclude purchased intangible amortization, restructuring costs, assets impairments, acquisition-related costs, and income tax items and **you describe these items as infrequent or unusual although you have reported similar items for multiple fiscal years**. Please note that Item 10(e)(1)(ii)(B) of Reg S-K prohibits you from adjusting a non-GAAP performance measure to **eliminate or smooth items** identified as non-recurring, infrequent or unusual, when the **nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years**. In addition, your non-GAAP **measures appear to exclude certain normal, recurring, cash operating expenses** which is inconsistent with the C&DIs.

# Potentially Misleading Non-GAAP Measures

*(cont'd)*

- Individually tailored measures

> - You present the non-GAAP measures Adjusted gross revenue and Accounts receivable before allowance, which reflect GAAP revenue and accounts receivable excluding implicit price concessions for payor disallowances and patient nonpayments. **These measures appear to substitute individually tailored revenue recognition and measurement methods** for those of GAAP as you are adjusting for amounts excluded from revenue under ASC 606. Please tell us how you considered Question 100.04.
> - We note the disclosure of the non-GAAP measure, Pre-PAA Taxable Equivalent NIM, excluding the impact of purchase accounting. **The exclusion of purchase accounting appears to use an individually tailored recognition and measurement method** which could violate Rule 100 (b) of Regulation G, since purchase accounting adjustments are recognized in interest income under GAAP. In addition, because this non-GAAP metric only excludes the effects of purchase accounting, it does not reflect true organic growth. Please remove these measures from future filings. Refer to Question 100.04.
> - Your adjusted earnings and adjusted diluted EPS measures include an adjustment for "acquisition intangible amortization". Excluding amortization of acquired intangible assets may result in non-GAAP measures based on individually tailored accounting principles. Tell us how you considered Question 100.04.

# Commercial Mortgage REITs (mREITs): "Core Earnings" to "Distributable Earnings"

- June to November 2020: CorpFin issued comment letters to two mREITs that "Core Earnings" should not exclude the unrealized portion of the provision for credits losses:

**SEC Comments to mREIT No. 1 :**

- June: We note on page X your period-to-period discussion with respect to the increase in the provision for credit losses, net, due primarily to the COVID-19 pandemic. Please tell us how you determined this adjustment was appropriate and if you intend to make similar adjustments to Core Earnings going forward.
- July: It appears **your presentation of Core Earnings, which excludes the provision for credit losses, substitute individually tailored recognition and measurement methods for those of GAAP** and could violate Rule 100(b) of Regulation G. Refer to Question 100.04 of C&DIs.
- October: We continue to believe your presentation of Core Earnings, which excludes the unrealized portion of the provision for credit losses, appears to substitute individually tailored recognition and measurement methods for those of GAAP and could violate Rule 100(b) of Regulation G, as discussed in Question 100.04 of the C&DIs. Please refrain from disclosing this performance measure, or any other performance measures that exclude the provision for credit losses, or portions of the provision for credit losses, in future filings.

**October Response:** While we respectfully disagree with Staff's position that Company's current Core Earnings presentation substitutes individually tailored recognition and measurement methods for those of GAAP, we will refrain from excluding the provision for credit losses, or portions of the provision for credit losses, from our Core Earnings presentation in future filings.

# Commercial Mortgage REITs (mREITs): "Core Earnings" to "Distributable Earnings" *(cont'd)*

- "Core Earnings": a non-GAAP financial measure commonly/historically used by mREITs, generally calculated as **GAAP net income excluding:** (i) non-cash equity compensation (ii) depreciation and amortization, (iii) unrealized gains/losses (including **unrealized provisions for credit losses**) and (iv) certain non-cash items.
  - Intended to depict current economic performance by excluding unrealized items as these involve significant estimates and judgments that may or may not materialize in the future
  - Since mREITs required to distribute at least 90% of taxable income to shareholders, Core Earnings widely used by mREIT research analysts and investors to predict mREIT's ability to cover dividends.
- Context of SEC Comments: Effective Jan. 1, 2020, ASU 2016-13 ("CECL" standard) required use of an "expected loss" credit model for estimating future credit losses of loans instead of "incurred loss". Becomes part of GAAP net income calculation.
  - BUT in 2020: The new CECL standard *plus* COVID-19 impact resulted in quarter-to-quarter volatility in <u>net income</u> amounts for many filers, due to impact of pandemic on loan loss assumptions (expected losses soared). So filers began to exclude CECL reserves in non-GAAP financial measures -- and CorpFin objected to this on the basis that these non-GAAP adjustments could make measures misleading.

# Commercial Mortgage REITs (mREITs): "Core Earnings" to "Distributable Earnings" *(cont'd)*

- Nov. 2020: mREIT no. 2 received CorpFin comment letter that its "Core Earnings" should not exclude the unrealized portion of the provision for credits losses.
  - mREIT no. 2 and NAREIT discussed with CorpFin and Chief Accountant and reasoned that exclusion is not misleading and the measure is useful for mREIT industry.
- Outcome: Per mREIT no. 2 and counsel -- CorpFin would not object to use of Core Earnings as long as measure is renamed (e.g. "Distributable Earnings") and accompanied by enhanced disclosure of its usefulness as an indicator of mREIT dividends. Staff said:
  - "Core Earnings" could be misleading since loan loss reserves are integral to earnings of a lender. Since name of measure should reflect what it represents, Staff would not object to "Distributable Earnings".
  - Include expanded disclosure on usefulness: (1) to maintain REIT status, mREITs must distribute substantially all its taxable income, (2) dividends are one of principal reasons investors invest in mREITs, (3) over time, measure has been a useful indicator of mREIT's dividends per share, and (4) measure is considered by mREIT in determining its dividend.
  - mREIT should provide clear disclosure on how mREIT reduces performance measures when it determines that loan losses have been "realized", including how it defines "realized".

# Reasons for Management's Use and Usefulness to Investors

- Expand on purpose and usefulness of non-GAAP financial measures
  - No boilerplate
- Sample SEC Comments:

> - We note your measure of Adjusted Gross Profit. Please revise your disclosures to explain in detail how you use this measure and why you believe the measure is useful to investors.
> - We note your narrative discussion of the non-GAAP measures of adjusted gross profit, adjusted gross profit margin, adjusted net earnings and adjusted net earnings per diluted share. Please expand your discussion on why management believes each of these non-GAAP measures is useful to investors, including adjusted operating income and adjusted operating margin. In this regard, you should explain what management considers to be "intrinsic operating results" and why excluding certain costs and adjustments to GAAP financial results is meaningful to an understanding of your business and also how an investor should understand these measures.
> - As previously requested, please expand your disclosures to provide substantive justification specific to your circumstances rather than boilerplate language included in your draft disclosure that clearly explains why each non-GAAP measure presented is useful to investors in accordance with Item 10(e)(1)(i)(c) of Regulation S-K.

# Liquidity vs. Performance Measures

- Distinguish and also remember prohibition on per share presentation of liquidity measures

> - We note that your key non-GAAP *liquidity* and *performance* measures include adjusted EBITDA and non-GAAP net income (loss). Please clarify whether these two measures are non-GAAP liquidity measures or non-GAAP performance measures.
> - Please ensure your disclosures appropriately characterize your non-GAAP measures as operating performance measures and/or liquidity or cash flow measures. For example, you appear to have characterized free cash flow as an operating performance measure. However, you reconcile free cash flow from net cash used for operating activities, which indicates free cash flow is a liquidity measure.
> - You disclose that you consider EBITDA and Adjusted EBITDA to be indicators of your ability to generate cash to service debt, fund capital expenditures, and expand your business and you reconcile these measures to net income and cash provided by operating activities. We note your disclosure that you do not consider these non-GAAP financial measures to be measures of your liquidity and they do not comply with the provisions of S-K Item 10(e)(1)(ii)(A). Please clarify these inconsistencies.
> - You disclose that Adjusted Free Cash Flow and Adjusted Free Cash Flow Conversion are non-GAAP measures used by management and your board to assess financial performance. Considering that your Adjusted Free Cash Flow is a liquidity measure and your Adjusted Free Cash Flow Conversion appears to comingle performance and liquidity measures, please explain how these non-GAAP measures are used to assess your financial performance. Please also expand your disclosure to explain how these non-GAAP measures provide useful information to investors.

# SEC Comment Letters – KPI Metrics

- Accompanying disclosures: (**i**) clear definition of metric and how calculated; (**ii**) reasons why metric provides useful information to investors; and (**iii**) how management uses metric in managing or monitoring business performance

- You refer to certain key performance indicators in your earnings calls. To the extent broadcast subscribers, unique users, or broadcast churn, are KPIs used in managing your business, consider revising to include a discussion of the measures in your MD&A, along with comparative period amounts, or explain why you do not believe this disclosure is necessary. Refer to Section III.B.1 of SEC Release No. 33-8350 and SEC Release 33-10751.
- In your earnings call, you discuss net revenue per client, success rates of items during a given period compared to the prior period, and inventory turnover. If these metrics are used by management to manage the business, and promote an understanding of company's operating performance, they should be identified as key performance indicators.
- You use the term customers as it relates to your *[X]* product and users as it relates to your *[Y]* product. Revise to define these terms and discuss how each are calculated. Disclose these metrics for the comparable prior period.
- We note your disclosure that you use "annual contracted revenues" as a key metric in your financial management of your business. Please define annual contracted revenues.
- Please revise to provide a clear definition of what constitutes a "session on your website." Disclose, as applicable, whether estimates or assumptions underlie the metric or its calculation. Clarify how metric is useful to investors and how management uses it.

# SEC Enforcement Actions

# COVID-19 Disclosures

- *1. December 4, 2020 Enforcement Action*
  - Company C made statements in 8-K press releases on March 23 and April 3, 2020 that its restaurants were "operating sustainably" during COVID-19 pandemic
    - March 23: "All of the Company's restaurants have transitioned to an **off-premise operating model** as required by state and local officials. The [*Company C*] restaurants have a long-standing business in the off-premise channel, with historical sales volumes approaching the size of many stand-alone restaurants, which is **enabling the Company's restaurants to operate sustainably at present under this model**."
    - April 3: "The [*Company C*] restaurants have a long-standing business in the off-premise channel, which enabled a **quick pivot to an off-premise only operating model** in all open restaurants as required by state and local officials. The Company has seen off-premise sales recently accelerate approximately 85% since the fiscal fourth quarter 2019 level. On an annualized basis, current off-premise sales would equate to over $3 million per unit, on average. **The restaurants are operating sustainably at present under this model."**



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# COVID-19 Disclosures *(cont'd)*

- *December 4, 2020 Enforcement Action (cont'd)*
  - BUT….
- Internal documents: Company losing $6 million cash per week and had 16 weeks of cash left (after already drawing last $90 million on credit facility)
- March 18: sent letters to landlords it would not be paying April rent due to "severe decrease in restaurant traffic [due to COVID-19 that] has severely decreased our cash flow and inflicted a tremendous financial blow to our business"
- Approaching lenders and PE funds to raise $100 million either in equity or debt
- "Sustainable" at the time only if certain corporate expenses excluded

# COVID-19 Disclosures *(cont'd)*

- *December 4, 2020 Enforcement Action (cont'd)*
  - SEC: Statements in 8-K press releases re COVID-19 impact on business operations and financial condition were materially false and misleading
  - **Penalty:** Company ordered to pay a civil penalty of $1250,000 and cease and desist from future violations
  - Stephanie Avakian, Director of the Division of Enforcement: "When public companies describe for investors the impact of COVID-19 on their business, they must speak accurately … The Enforcement Division, including the Coronavirus Steering Committee, will continue to scrutinize COVID-related disclosures to ensure that investors receive accurate, timely information, while also giving appropriate credit for prompt and substantial cooperation in investigations."

# Non-GAAP Financial Measures

- *2. December 26, 2018 Enforcement Action*
  - Company A presented adjusted EBITDA in the headline of its 2017 fiscal year end earnings release and adjusted EBITDA, adjusted net income and adjusted net income per share in the highlights of its 2018 first quarter earnings release
    - In the headline of an earnings release, company presented its adjusted EBITDA for the fiscal year and stated that adjusted EBITDA was up 8% year-over-year, without mentioning the company’s net income or loss (the comparable GAAP financial measure) in the headline
    - In the headline of a subsequent quarterly earnings release, company presented its adjusted EBITDA for the quarter and stated that adjusted EBITDA was up 7% year-over-year, without mentioning the company’s net income or loss in the headline
    - In its quarterly earnings release, company listed “FIRST QUARTER 2018 HIGHLIGHTS,” including bullet points noting (with dollar amounts) that adjusted EBITDA was up 7%, adjusted net income was up 26%, and adjusted net income per share was up 10%, without providing comparable GAAP financial measures for net income or loss in the HIGHLIGHTS section

# Non-GAAP Financial Measures *(cont'd)*

- *December 26, 2018 Enforcement Action (cont'd)*
  - Company reported comparable GAAP measures several paragraphs later
  - SEC found that company violated Item 10(e) of Regulation S-K when it failed to present the comparable GAAP measure with equal or greater prominence
  - This case is a departure from past SEC practice of using comment letters to address violations of the equal or greater prominence rule, and is an indication that, in appropriate cases, the SEC is prepared to bring enforcement action against issuers over noncompliant disclosures of non-GAAP financial measures
  - **Penalty:** Company ordered to pay a civil penalty of $100,000 and cease and desist from future violations

# Non-GAAP Financial Measures *(cont'd)*

- *3. August 1, 2019 Enforcement Action*
  - SEC charged Company B, a publicly-traded REIT, and 4 executives (CEO, CFO, CAO and SVP of Accounting) with fraud in connection with scheme to manipulate a key non-GAAP metric relied on by analysts and investors to evaluate company's performance
    - Execs improperly adjusted same property net operating income (SP NOI) and SP NOI growth rate in order to report quarterly numbers that hit Company's publicly-issued growth targets
    - SP NOI is adjusted version of NOI (defined by REITs as rental income less rental operating expenses such as property operating expenses, real estate taxes, and bad debt expense). SP NOI represents NOI of "Same Property Pool," or pool of properties owned by REIT as of the end of both the current reporting period and same reporting period in prior year
    - Used tactics such as (i) using an account referred to internally as a "cookie jar" to improperly time the recognition of revenue (ii) incorporating lease termination income into SP NOI, contrary to company's public representation that it excluded lease termination income from its calculation of SP NOI and (iii) improperly lowering the prior year's SP NOI in order to make the current quarter's SP NOI Growth Rate appear higher

# Non-GAAP Financial Measures *(cont'd)*

- *August 1, 2019 Enforcement Action (cont'd)*
  - SEC found company violated antifraud provisions of federal securities laws and Rule 100(b) of Regulation G, and filed false and misleading annual, quarterly and current reports with the SEC
  - **Penalty:** Company ordered to pay $7 million penalty and comply with undertakings, including retaining independent consultant to review and assess controls relating to the calculation and presentation of non-GAAP measures including SP NOI
  - In a parallel action, the U.S. Attorney's Office for SDNY filed criminal charges alleging securities fraud, making false statements in SEC filings and filing false certifications against the four executives. CAO and SVP have pleaded guilty and are cooperating with the DOJ.

# Enforcement Action on KPIs

- *4. September 24, 2019 Enforcement Action*
  - SEC charged Company C and its CEO with engaging in a fraudulent scheme to overstate revenue by approximately $50 million and making false and misleading statements about key performance metrics
  - Made false and misleading public disclosures regarding company's customer base and flagship product and CEO lied to internal accountants and external audit firm. Scheme enabled it to artificially exceed analysts' consensus revenue target in 7 consecutive quarters and create illusion of smooth and steady growth in business
    - Total number of customers and net new customers added per quarter: In 2014 and 2015, in an effort to conceal the fact that quarterly growth in customer total had slowed or was declining, CEO approved and implemented multiple changes to methodology by which the quarterly customer count was calculated. Changes were not applied retroactively nor disclosed to the public

# KPIs *(cont'd)*

- *September 24, 2019 Enforcement Action (cont'd)*
  - vCE revenue growth: In an effort to conceal the decline in company's flagship product (vCE), company manipulated which sales were classified as vCE revenue. At CEO's direction, company picked a small number of high-dollar agreements, generally involving the delivery of historical data, and directed them to be re-classified as vCE even though they did not involve the sale of an actual vCE product. Company disclosed in quarterly earnings calls that its year-over-year vCE revenue grew by 53% in the 2015 Q3 and by 56% in 2015 Q4.
  - Company also entered into non-monetary transactions with counterparties to exchange sets of data without any cash consideration, but it recognized revenue on these transactions based on the fair value of the data it delivered, which had been improperly increased to inflate revenue.
  - **Penalty**: Company and CEO ordered to pay a civil penalty of $5 million and $700,000, respectively. CEO agreed to reimburse company $2.1 million representing profits from sale of company stock and incentive-based compensation pursuant to Section 304(a) of the SOX and to SEC order barring him from serving as an officer or director of a public company for 10 years.

# Audit Committee and Management Roles

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# Audit Committee's "Critical Gatekeeper Role"

- SEC Staff Issuances and Reminders:
  - Appropriate and effective disclosure controls and procedures on the use of non-GAAP financial measures and key metrics should be established by registrants
  - Increase audit committee involvement and dialogue with stakeholders regarding the use and presentation of non-GAAP measures and KPIs
  - Emphasize important "critical gatekeeper" role audit committee members play in ensuring credible, reliable financial reporting, including compliance with C&DIs
  - AC members should seek to understand management's judgments in design, preparation and presentation of these measures and how measures might differ from approaches followed by other registrants
  - Oversight of management's activities is crucial for investor protection
  - Important for both auditors and audit committees to keep and maintain a direct and open line of communication
  - AC has important role overseeing external auditors

# Audit Committee's Role in Financial Reporting

- *Statement on Role of Audit Committees in Financial Reporting and Key Reminders Regarding Oversight Responsibilities (December 30, 2019)* by then SEC Chair Clayton, SEC Chief Accountant Teotia and CorpFin Director Hinman)

  *"It is important that audit committees understand whether—and how and why—management uses non-GAAP measures and performance metrics, and how those measures are used in addition to GAAP financial statements in the company's financial reporting and in connection with internal decision making. We encourage audit committees to be actively engaged in the review and presentation of non-GAAP measures and metrics to understand how management uses them to evaluate performance, whether they are consistently prepared and presented from period to period and the company's related policies and disclosure controls and procedures."*

# Audit Committee's Role in Financial Reporting

- *Center for Audit Quality's "Non-GAAP Measures: A Roadmap for Audit Committees" (March 2018)*
  - Audit committees have important responsibility to oversee financial reporting process and external audit
  - Can act as a bridge between management and investors, assess management's reasons for presenting non-GAAP measures and evaluate sufficiency of related disclosures
  - CAQ lays out a three-fold roadmap for audit committee members:
    1. Identify key discussion topics with management, counsel and external auditors,
    2. Understand the external auditor's role regarding non-GAAP measures, and
    3. Adopt leading practices to support presentation of high-quality non-GAAP measures

# Audit Committee’s Role in Financial Reporting

- *CAQ’s Non-GAAP Measures: A Roadmap for Audit Committees*
  1. AC members should consider topics for dialogue:
     - Ask management whether it has internal guidelines for determining how non-GAAP measures are generated, calculated and presented; seek perspective of counsel on non-GAAP measures; ask company to benchmark such measures to peers; and find out what disclosure controls and procedures are in place.
  2. While external auditors do not audit non-GAAP measures as part of financial statement or ICFR audits, AC and management may consider external auditors as a resource when evaluating such measures and ask them to perform certain procedures, such as testing controls related the preparation and use of such measures in light of management’s policies, and report results to them
  3. AC and management should consider adopting best practices, *e.g*. subjecting non-GAAP measures to robust disclosure controls, and adopting guidelines to follow when preparing and presenting non-GAAP measures to stakeholders

# Audit Committee's Role in Financial Reporting

- *CAQ's "Role of Auditors in Non-GAAP Financial Measures and Key Performance Indicators" (2020)*
- In executing oversight of financial reporting process and external audit, audit committees may want to consider the following questions:
  - Does the company have an internal policy for determining how non-GAAP financial measures and KPIs are generated, calculated, and presented?
  - Are the non-GAAP financial measures and KPIs transparently disclosed in such a way that the users can understand the basis for their calculations?
  - Does the company have internal controls and DCPs over non-GAAP financial measures and KPIs, and are they precise enough to detect a material misstatement?
  - Do the non-GAAP financial measures or KPIs represent a balanced picture (i.e., is the company including both negative and positive adjustments)?
  - How do the company's non-GAAP financial measures and KPIs compare to those of other companies in the industry?
  - What impact do economic volatility and other uncertainties, such as COVID-19, have on the non-GAAP financial measure, and are the related adjustments, if any, appropriate and expected to be nonrecurring?

# Audit Committee's Role in Financial Reporting

- Corporate governance disclosures
  - Audit committee/Audit committee reports
    - Consider the statements made by the Chief Accountant, as well as the PCAOB's conversations with audit committee chairs
    - How has the audit committee responded to:
      - Complexities of company staff and audit teams working from home?
      - Changes to audit procedures or to the company's accounting policies?
      - Challenges relating to the company's control environment?
    - Has the committee vetted non-GAAP COVID-19 adjustments? Impairments? Changes to estimates or to policies requiring judgment?

# Practical Suggestions for Ongoing Compliance

# Practical Tips for Compliance

- Understand rules and learn from SEC comments and guidance
- Involve disclosure committee and management
- Formalize and strengthen audit committee role and oversight functions
- Ask the basic questions:
  - Why are you using a non-GAAP measure or KPI, and how is it useful to investors?
  - Is the non-GAAP measure or KPI clearly defined and disclosed?
  - Are you giving non-GAAP measures no greater prominence as required?
  - Are your explanations of how you're using non-GAAP measures accurate and complete, and not boilerplate?
  - Are there are appropriate controls over the calculation of non-GAAP measures?
  - Are changes in methodologies or calculations sufficiently explained and disclosed?

# Practical Reminders

- Ensure that each non-GAAP financial measure is accurately defined, described and captioned and reconciled to the most directly comparable GAAP measure.
- Management should monitor the use of non-GAAP financial measures by comparable companies and financial professionals.
- Ensure that nature of adjustments to arrive at non-GAAP financial measures has a reasonable basis and is customary among peer companies. Avoid cherry picking and individually-tailored accounting measures.
- Because Regulation G applies to all public disclosures, orally or written, companies must take a closer look at how and when they present measures in press releases, webcasts, investor presentations, earnings releases, conference calls and other disclosures.
- Remember that Non-GAAP financial measures should merely supplement, not substitute, GAAP measures!

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